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Chapter One

Using This Volume's Options for Deficit Reduction

Federal policymakers face a difficult set of challenges in 1995. Significant strides in deficit reduction made since 1990 and the economic recovery from the 1990 recession have improved the short-run outlook for the deficit substantially. Nevertheless, the outlook of the Congressional Budget Office (CBO) over the longer term is for a deficit that increases both in nominal terms and as a percentage of gross domestic product (GDP). At the same time, the Congress is considering a proposed balanced budget amendment to the Constitution that could take effect as soon as fiscal year 2002. However, with or without such an amendment, if the budget is to be balanced within the next seven years, the Congress and the President will need to act soon on another round of deficit reduction.

Reducing the deficit is critical because it can significantly affect the ability of the economy to sustain real growth and remain healthy in the long run. Amid a concern that U.S. living standards may grow more slowly in coming decades than they did during most of the postwar period, reducing the budget deficit continues to be an important focus of attention because it will increase national saving. In fact, reducing the deficit is the single most reliable way to improve national saving. Over the long run, a permanently higher rate of saving would lower real interest rates, stimulate new investment, increase productive capacity, enlarge the share of productive investment that would remain with U.S. investors, reduce foreign investment in the United States, and raise the nation's standard of living.

The concern for the deficit and its effect on long-term productivity has provided the impetus for two recent multiyear deficit reduction packages, each of which has involved substantial spending reductions and revenue increases. As a result, the deficit outlook today is much more positive than it would have been without those actions. In 1990, policymakers enacted spending reductions and tax increases that reduced cumulative deficits by an estimated $500 billion over five years. The 1993 budget agreement is estimated to have reduced cumulative deficits by more than $400 billion.[1] Despite that progress, however, the long-run outlook is for the deficit to begin to turn up again late in this century and continue to increase as a percentage of GDP after the turn of the century if present programs and tax laws continue.

The Budget Outlook Through 2005

The Congressional Budget Office projects that the deficit will decline in 1995 for the third year in a row. But according to CBO projections, that trend will then stop. Under current taxing and spending policies, and under CBO's assumptions about the

1. For additional details on the composition of the two deficit reduction packages, see Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 1994), pp. 4-7.

economy, the deficit will climb again--from $176 billion this year to $207 billion in 1996 and $222 billion in 1998, the last year covered by the limits, or caps, on discretionary spending created by the Budget Enforcement Act of 1990 (BEA) and extended by the 1993 budget agreement. (See Box 1-1 for information about the changes in the budget process made by the Budget Enforcement Act.) As measured by gross domestic product, the deficit will stubbornly hover just around 3 percent for the next five years.

Box 1-1.
The Discretionary Spending Limits and PAYGO

The 1990 deficit reduction package included the Budget Enforcement Act (BEA), whose primary purpose was to ensure that the savings agreed to in the deficit reduction accord would be realized. Since the BEA set up separate enforcement procedures for discretionary spending and for mandatory spending, it is important that readers of this volume understand the differences between those types of federal spending. Discretionary spending is spending controlled through the annual appropriation process, whereas mandatory spending (which includes entitlements such as Social Security and Medicare) represents programs for which the level of spending is not controlled directly, but is driven by the provisions of underlying legislation governing conditions that must be met to receive benefits.

Two major sets of rules for enforcement were included under the BEA. The first of those was the discretionary spending caps on budget authority and outlays for fiscal years 1991 through 1995 (which were extended to 1998 by the Omnibus Budget Reconciliation Act of 1993). Exceeding the caps prompts a sequestration (an across-the-board cut) of discretionary spending. The second major enforcement mechanism included in the BEA is the pay-as-you-go (PAYGO) process. That set of rules requires that legislative actions affecting entitlements and other mandatory spending (excluding Social Security, which has its own limiting rules) as well as revenues must not increase the deficit in any year (originally through 1995, but a subsequent revision extended PAYGO through 1998). If that condition is not met, the PAYGO discipline is enforced through a separate sequestration of the resources available to a prescribed and limited number of mandatory programs, such as Medicare and farm price supports.

The Congressional Budget Act of 1974 requires CBO to prepare five-year estimates of the budget outlook and budgetary legislation. But longer-term extrapolations are critical, particularly in light of the current debate over a constitutional amendment to require a balanced budget. Under current spending and taxing policies, CBO projects that the deficit will top $400 billion in 10 years--more than twice today's level (see Table 1-1). That projection assumes that discretionary spending resumes growing with inflation after 1998, when the caps expire. Because the economy will grow, the deficit will not climb quite as dramatically in relation to GDP. Still, it will inch up fairly steadily--from 2.5 percent of GDP in 1995 to 3.6 percent in 2005.

Why does the deficit grow? Neither discretionary spending, which is projected to decline as a percentage of gross domestic product, nor revenues and nonhealth entitlements (including Social Security) appear to be the culprit. The root cause of growing deficits therefore remains the major health care entitlement programs. Although growth has slowed somewhat, spending for both Medicaid and Medicare is still projected to rise by 10 percent a year through 2005, propelling those expenditures to a combined 6 percent of GDP by that time (up from 3.8 percent today). Those two big health care programs will overtake another entitlement program--Social Security--in size by 2000 and even catch up to total discretionary spending by 2005. In fact, if Medicare and Medicaid were to stay constant as a percentage of GDP instead of increasing, the deficit in 2005 would be only about $90 billion, or 0.8 percent of GDP.

Moreover, between now and 2005, Social Security spending will barely change as a percentage of GDP from today's level of 4.7 percent. In 2005, the final year of that extended projection, the first members of the baby-boom generation will still be several years away from eligibility for Social Security retirement benefits and Medicare. When they do reach eligibility, however, spending for both programs will skyrocket. Thus, the deficit outlook will signifi-

Table 1-1.
The Budget Outlook Through 2005 with Discretionary Inflation After 1998 (By fiscal year)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
In Billions of Dollars											
Revenues	1,355	1,418	1,475	1,546	1,618	1,697	1,787	1,880	1,978	2,082	2,191
Outlays											
Discretionary	544	549	548	547	566	585	605	626	647	669	692
Mandatory											
Social Security	334	352	371	390	411	433	456	481	507	534	563
Medicare	176	196	217	238	262	286	314	344	379	417	460
Medicaid	90	100	111	123	136	149	164	179	196	214	234
Civil Service and Military Retirement	66	68	71	75	80	83	87	91	96	100	105
Other	179	183	192	199	208	220	224	231	239	247	256
Subtotal	845	899	962	1,026	1,097	1,173	1,245	1,328	1,417	1,513	1,617
Deposit insurance	-16	-9	-5	-5	-3	-3	-3	-3	-3	-3	-4
Net interest	235	260	270	279	294	310	325	344	365	387	412
Offsetting receipts	-77	-73	-76	-79	-82	-84	-88	-93	-97	-102	-106
Total	1,531	1,625	1,699	1,769	1,872	1,981	2,084	2,202	2,329	2,465	2,611
Deficit	176	207	224	222	253	284	297	322	351	383	421
Social Security Surplus	69	73	78	84	90	96	104	111	119	128	137
Hospital Insurance Surplus	3	-2	-7	-12	-19	-25	-32	-39	-48	-59	-71
Debt Held by the Public	3,617	3,838	4,077	4,317	4,589	4,891	5,207	5,547	5,917	6,318	6,757
As a Percentage of GDP											
Revenues	19.3	19.2	19.0	19.0	18.9	18.8	18.8	18.8	18.8	18.8	18.8
Outlays											
Discretionary	7.7	7.4	7.1	6.7	6.6	6.5	6.4	6.3	6.2	6.1	6.0
Mandatory											
Social Security	4.7	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Medicare	2.5	2.7	2.8	2.9	3.1	3.2	3.3	3.5	3.6	3.8	4.0
Medicaid	1.3	1.4	1.4	1.5	1.6	1.7	1.7	1.8	1.9	1.9	2.0
Civil Service and Military Retirement	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Other	2.5	2.5	2.5	2.4	2.4	2.4	2.4	2.3	2.3	2.2	2.2
Subtotal	12.0	12.2	12.4	12.6	12.8	13.0	13.1	13.3	13.5	13.7	13.9
Deposit insurance	-0.2	-0.1	-0.1	-0.1	a	a	a	a	a	a	a
Net interest	3.3	3.5	3.5	3.4	3.4	3.4	3.4	3.4	3.5	3.5	3.5
Offsetting receipts	-1.1	-1.0	-1.0	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Total	21.8	22.1	21.9	21.7	21.8	22.0	22.0	22.1	22.2	22.3	22.5
Deficit	2.5	2.8	2.9	2.7	3.0	3.1	3.1	3.2	3.3	3.5	3.6
Social Security Surplus	1.0	1.0	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.2	1.2
Hospital Insurance Surplus	a	a	-0.1	-0.1	-0.2	-0.3	-0.3	-0.4	-0.5	-0.5	-0.6
Debt Held by the Public	51.4	52.1	52.6	53.0	53.5	54.3	54.9	55.6	56.4	57.2	58.1

SOURCE: Congressional Budget Office.
a. Less than 0.05 percent of GDP.

cantly deteriorate beyond even the extended projection period.[2]

Balancing the Budget by 2002

Reducing the deficit substantially is certainly desirable and could also be necessary to comply with the provisions of a proposed balanced budget amendment to the Constitution. Most of the amendments currently being considered provide that the requirements of the amendment would take effect in fiscal year 2002 or the second fiscal year following ratification, whichever is later. CBO estimates that the deficit in 2002, if current policies continue, would be $322 billion. Since a deficit reduction of that size undertaken in one or two years could cause economic disaster, the Congress needs to take further action soon if it wishes to balance the budget or sharply reduce the deficit in the next several years.

In 2002, federal spending is projected to be $2.2 trillion, and revenues are projected to be $1.9 trillion. Of the roughly $2.2 trillion in spending, approximately $1.3 trillion (or 60 percent) would result from outlays for mandatory programs (mostly for Social Security, Medicare, and Medicaid) and $626 billion (28 percent) would stem from discretionary spending. (Defense spending would represent approximately half of the discretionary amount if current spending patterns persist.) The remainder comprises a combination of net interest, deposit insurance, and offsetting receipts.

The task of balancing the budget would become even more arduous if particular options were precluded. For example, some policymakers have indicated a desire to balance the budget without raising taxes, thus implying that deficit reduction would come entirely from cuts in spending. Others have advocated exempting certain categories of spending from budget reduction. Those approaches have implications for the magnitude of the actions that might be necessary to balance the budget.

By way of illustration, consider the magnitude of the policy changes necessary to achieve a balanced budget by 2002. The broadest deficit reduction base would include both spending cuts and tax increases. If half of any reductions necessary to achieve a deficit of zero in 2002 were to come from revenue increases and half from spending cuts (with all spending, except interest on the debt, included in the base), revenues in 2002 would need to be increased by almost 7 percent and spending decreased by approximately the same percentage.

Now consider what would happen if all deficit reductions were to come from spending alone, excluding net interest, offsetting receipts, and deposit insurance. If spending was to be cut across the board, a 13 percent reduction from the projected 2002 level would be necessary to bring spending in line with revenues in that year. If Social Security outlays were excluded from the base that would be subject to spending reductions, the necessary cut in the remainder of the budget would increase to 17 percent. If, in addition to excluding Social Security, defense spending was maintained at real 1995 levels, the required reduction in the remainder of the budget to achieve budgetary balance would increase to 22 percent. The base included for that 22 percent would comprise all non-Social Security outlays for mandatory spending (primarily Medicare and Medicaid) and all nondefense discretionary spending (including all outlays, for example, for veterans assistance, unemployment insurance, law enforcement, highway programs, national parks, space exploration, cancer research, and education assistance).

For illustrative purposes, CBO has laid out one of many possible paths to a balanced budget in 2002 (see Table 1-2). Starting from a baseline that assumes that discretionary spending is adjusted for inflation after 1998 (when the BEA's caps on discretionary spending expire), that path shows the deficit reduction that would be necessary to eliminate gradually the projected $322 billion deficit for 2002.

Over the entire 1996-2002 period, the savings in CBO's illustrative path that result directly from policy changes total more than $1 trillion. When the resulting savings in debt-service payments that will accompany lower deficits are included, the total exceeds $1.2 trillion. That path and the resulting $1.2

2. For more details concerning the underlying economic assumptions and other assumptions used to make these budget projections, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1996-2000* (January 1995).

trillion are illustrative only. The actual amount of cumulative deficit reduction over the 1996-2002 period will depend on the timing and the exact nature of the policies enacted to achieve a balanced budget in 2002.

The required savings from policy changes would be smaller and the debt-service savings greater if, as CBO anticipates, ongoing deficit reduction efforts over this period result in lower interest rates. CBO believes that by 2000 interest rates could be as much as 1 percentage point lower than it currently forecasts if spending cuts and tax increases that would lead to a balanced budget have been enacted and the financial markets are convinced that policymakers will maintain those policies. CBO estimates that such a drop in interest rates would lower projected federal interest payments--and the amount of savings from policy changes needed to balance the budget--by almost $140 billion over the 1996-2002 period.

How to Use This Report

This volume presents a menu of options that can be used to make policy choices to reduce the deficit. Based on their own policy preferences, users of this report can select options that could contribute to decreasing federal red ink. The specific options that are included in this volume came from various sources, such as past Presidential budget proposals, past legislative proposals, and the suggestions of various private groups. CBO staff developed others to illustrate cuts in the broadest possible range of programs and to provide variations of options presented in earlier volumes. In none of these cases is the inclusion of an option intended to communicate its endorsement by CBO. Further, although this particular menu is meant to cover a broad range of options, the exclusion of options does not imply that they lack merit. Finally, variations of these options are also possible.

Table 1-2.
Illustrative Deficit Reduction Path (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	1996-2002
CBO Baseline Deficit with Discretionary Inflation After 1998	176	207	224	222	253	284	297	322	n.a.
Deficit Reduction									
Policy changes[a]	0	-32	-65	-97	-164	-194	-225	-259	-1,035
Debt service	0	-1	-4	-10	-19	-31	-46	-64	-175
Total Deficit Reduction	0	-33	-69	-106	-182	-225	-271	-322	-1,210
Resulting Deficit	176	174	155	116	71	59	26	b	n.a.

SOURCE: Congressional Budget Office.

NOTES: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998.

n.a. = not applicable.

a. These changes represent only one of a large number of possible paths that would lead to a balanced budget. The exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the Administration. The path illustrated in this table is not based on any specific policy assumptions but does assume that policies are fully phased in by 1999.

b. Surplus of less than $500 million.

For example, tax rates could be raised by more or less than is contained in a specific option, as could spending. The decision about whether to adopt any of the options is, of course, for elected officials to make.

The policy options for deficit reduction, which include both those that would decrease spending and those that would increase revenues, are presented in the four remaining chapters of this report. Chapters 2 and 3 cover the discretionary programs--national defense (including international programs) in Chapter 2 and domestic programs in Chapter 3. Chapter 4 covers entitlements and other mandatory programs and also presents options that would raise user fees. Chapter 5 discusses a variety of options that would raise tax revenues.

For each option, this volume presents the pros and cons of the proposal, along with estimates of the effect that it would have on the deficit between fiscal years 1996 and 2000. For options covering national defense, mandatory spending, and revenues, the tables present a single set of estimates. For international and domestic discretionary programs, however, most of the options show two sets of estimates. The first indicates how much would be saved compared with projected spending if the 1995 funding level was held constant in nominal terms through 2000. Savings are shown for any year in which the option would result in spending below the 1995 funding level of the program.

The second set of numbers shows how much would be saved compared with the 1995 appropriation level adjusted for inflation through 2000. Thus, the baselines used for estimating savings for individual options do not incorporate the overall limits on spending for discretionary programs imposed through 1998 by the Budget Enforcement Act. Those limits were reflected in the estimates for discretionary spending presented in Table 1-1.

Specific Uses to Which the Options Could Be Put

Many possible uses exist for the options presented in this volume. For example, options in Chapters 2 and 3 could assist the Congress and the Administration in complying with the limits on discretionary spending that exist through 1998. Since those limits would not permit discretionary spending to grow as rapidly as inflation, the options that contemplate cuts in discretionary spending might be used to assist in meeting the existing targets. Users who wish to pursue options for that purpose should use the estimates calculated in the category labeled "1995 Funding Level Adjusted for Inflation" for domestic and international discretionary programs. Those savings are also a measure of the reduction in real resources that would result from adopting that option.

Options presented in this volume might also be used to finance tax cuts, as some Members of Congress are contemplating and as the Administration has proposed. Users seeking options that would help pay for reductions in revenues cannot, however, use reductions in discretionary spending as offsets under the BEA's rules. Therefore, all of the options that could be used to pay for tax cuts appear in Chapters 4 and 5.

Finally, options in this volume might be used to construct a large-scale deficit reduction plan such as could be necessary if the budget was to be balanced by 2002. Although estimates are not presented for fiscal years after 2000 because CBO does not produce a detailed baseline beyond five years, nonetheless users might want to use this volume to select deficit reduction options that move the federal government within striking distance of a balanced budget by 2000, so as to be able to hit the target by 2002.

The illustrative path presented in Table 1-2 results in a deficit of $59 billion in 2000. The size of the policy changes necessary to meet that target in 2000 differs depending on the starting point (see Table 1-3). If users start from a baseline that assumes that discretionary programs grow with inflation after 1995, $722 billion in policy changes would be necessary between 1996 and 2000 to meet the $59 billion target in 2000 (another $86 billion in debt-service savings are assumed to accrue from the reduced deficits). Users who start from that baseline should use the estimates calculated from the category titled "1995 Funding Level Adjusted for Inflation" for the international and domestic discretionary options. Note that this baseline represents higher discretionary spending, and therefore higher deficits, than the baseline presented in Tables 1-1 and 1-2, since it does not assume compliance with the BEA's caps for 1996 through 1998.

Alternatively, some policymakers have suggested that the starting point for deficit reduction should already assume a freeze in discretionary spending through 2000. The dollar value of additional policy reductions required from such a baseline to meet the $59 billion target would be $485 billion (another $59 billion in debt-service savings would accrue under this option). But using a freeze as a starting point means that readers should use the savings estimates computed from the "1995 Funding Level" category accompanying the international and domestic discretionary options in Chapters 2 and 3. Users should also keep in mind that, by implicitly choosing a starting point that assumes a freeze on all discretionary spending through 2000, they are assuming at the start that there will be a real reduction of $237 billion in discretionary resources over the five years from the level that would be implied by an inflation-adjusted baseline. Moreover, unless gains in efficiency are

Table 1-3.
Deficit Reduction Necessary to Meet Illustrative Path Under Different Baseline Assumptions, 1996-2000
(By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	1996-2000
	Savings from Baseline Assuming Discretionary Inflation[a]						
Baseline Deficit	176	212	251	270	306	342	n.a.
Deficit Reduction							
Policy changes	0	-37	-91	-141	-210	-242	-722
Debt service	0	-1	-6	-13	-25	-41	-86
Total Deficit Reduction	0	-39	-96	-154	-235	-283	-808
Resulting Deficit	176	174	155	116	71	59	n.a.
	Savings from Baseline Without Discretionary Inflation[b]						
Baseline Deficit	176	201	222	220	233	242	n.a.
Deficit Reduction							
Policy changes	0	-26	-63	-95	-145	-156	-485
Debt service	0	-1	-4	-9	-17	-28	-59
Total Deficit Reduction	0	-27	-67	-105	-162	-183	-544
Resulting Deficit	176	174	155	116	71	59	n.a.

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

a. Baseline assumes current law for mandatory spending and revenues and an annual increase in discretionary spending for inflation from 1995 levels.

b. Baseline assumes current law for mandatory spending and revenues and a freeze on all discretionary spending at 1995 levels.

sufficient to compensate for increases in prices, freezing spending at the 1995 level would require a decrease in a program's services or benefits.

Recent Clinton Administration defense plans could be used as a source for part of the savings needed to bridge the gap between the inflation-adjusted baseline and the baseline without discretionary inflation. Compared with the inflation-adjusted baseline, for example, the Administration's 1995 budget plan (as modified by the Congress) would have reduced outlays for defense by $12 billion in 1996, $20 billion in 1997, and $139 billion over the 1996-2000 period (see Table 2-3 on page 17 for additional details). Consequently, real reductions of an additional $100 billion over the five-year period in nondefense discretionary would be needed to reach the frozen 1995 spending level. If users did not choose to employ the defense reductions implicit in the President's plan of a year ago, they would need to make larger reductions in nondefense discretionary spending.

Other General Caveats in Using This Volume

Users of *Reducing the Deficit* should note several other caveats. First, although all of the options, if devoted to deficit reduction, would reduce federal interest costs, those savings are not included in the calculations accompanying the individual options. Ordinarily, when CBO is presented with a detailed budgetary plan, the savings for each option are assessed as in this volume, then the additional interest savings are computed (as is done in the illustrative paths shown in Tables 1-2 and 1-3). Moreover, when such budget packages are put together, one can adjust for any interactions among the parts that would raise or lower the savings--something that cannot be done for the options discussed here. The estimates also do not take into account the possible gains or losses in GDP or decreases in interest rates associated with large-scale deficit reduction. Instead, all options are examined using CBO's current economic projections.

Second, if used for deficit reduction, virtually all of the options presented here would in isolation reduce employment temporarily. Accordingly, that particular drawback is not noted in each discussion. Similarly, all of the proposals to reduce grants to state and local governments would make their financial status worse, and that effect also is not repeated in each discussion.

Third, some options may not be scored as meeting the Budget Enforcement Act's requirements for implementation, even though the options would reduce the deficit. The BEA created separate enforcement mechanisms for discretionary spending, Social Security, and revenues and other mandatory spending. An example of an option that would reduce the deficit but would not count under the Budget Enforcement Act would be a reduction in Social Security spending, which would not enter either the discretionary or pay-as-you-go (PAYGO) calculus, since Social Security was given its own limiting rule in the act. Generally, if the savings cannot be counted under the BEA, that caveat is noted in the discussions of individual options.

Fourth, "credit" is not given in the savings estimates for sales of government assets, such as buildings or land. Asset sales have not been scored as reducing the deficit since 1987, when the Balanced Budget and Emergency Deficit Control Reaffirmation Act prohibited such scoring; its rationale was that the sale of assets did not permanently affect the deficit. Thus, although government assets are sold from time to time, such sales cannot be counted to determine compliance either with the discretionary spending limits or with PAYGO. For that reason, CBO has included no proposals in this volume for which the sale of assets would yield the only savings. That choice was made mainly because the proceeds from such sales cannot be scored under current budget law; no judgment is implied concerning the desirability of selling government assets. In fact, at least one option is included that involves the sale of a government asset because the sale of that asset carries with it other savings that result from a reduction in direct appropriations.

Finally, subsequent CBO cost estimates, which are required to accompany any bill reported by a Congressional committee (with the exception of tax bills, for which estimates of the Joint Committee on Taxation are required by law) may not exactly match the numbers shown in this report. The reason is that policy proposals on which the cost estimates are